INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	2
Argument	5
Conclusion	10
Appendix	11

CITATIONS

Cases:

B. Forman Co. v. *Commissioner*, 453 F. 2d 1144, certiorari denied, 407 U.S. 934	8
Biltmore Homes, Inc. v. *Commissioner*, 288 F. 2d 336, certiorari denied, 368 U.S. 825	6
Brown Printing Co. v. *Commissioner*, 255 F. 2d 436	8
Challenger, Inc. v. *Commissioner*, 23 T.C.M. 2096	4
Clark v. *Commissioner*, 266 F. 2d 698	5
Commissioner v. *First Security Bank of Utah*, 405 U.S. 394	8
Holsey v. *Commissioner*, 258 F. 2d 865	7
Limericks, Inc. v. *Commissioner*, 165 F. 2d 483	5
Midland Ford Tractor Co. v. *Commissioner*, 277 F. 2d 111	8
Rubin v. *Commissioner*, 429 F. 2d 650, on remand, 56 T.C. 1155, affirmed *per curiam*, 460 F. 2d 1216	7, 8
Sachs v. *Commissioner*, 277 F. 2d 879, certiorari denied, 364 U.S. 833	5
Sammons v. *United States*, 433 F. 2d 728, certiorari denied, 402 U.S. 945	6, 9
Southeastern Canteen Co. v. *Commissioner*, 410 F. 2d 615	8
Tennessee-Arkansas Gravel Co. v. *Commissioner*, 112 F. 2d 508	8
Waldheim v. *Commissioner*, 244 F. 2d 1	5
Worcester v. *Commissioner*, 370 F. 2d 713	6

Page

Statutes and regulations:
Internal Revenue Code of 1954 (26 U.S.C.):
Sec. 61 ..... 2, 7, 8, 11
Sec. 162 ..... 2, 8, 9, 11
Sec. 301 ..... 2, 11
Sec. 301(c) 5
Sec. 316 ..... 2, 12
Sec. 316(a) 5
Sec. 482 ..... 2, 7, 8, 9, 13
Sec. 531 6
Treasury Regulations on Income Tax, § 1.61-1(b) (26 C.F.R.) 8

In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-810

R. L. GRAVES, FLORA J. GRAVES, R. L. AND FLORA J. GRAVES, AND SPARKS NUGGET, INC. AS TRANSFEREE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (Pet. App. 1-47) is reported at 29 T.C.M. 318. The opinion of the court of appeals (Pet. App. 48-62) is reported at 458 F. 2d 631.

JURISDICTION

The judgment of the court of appeals was entered on April 6, 1972 (Pet. App. 48). A petition for rehearing was denied on September 11, 1972 (Pet. App. 63). The

petition for certiorari was filed on December 4, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below correctly held that petitioners Flora J. Graves and R. L. Graves constructively received dividends when funds were transferred, under the guise of purported rental payments, from one of their wholly-owned corporations to others.

STATUTES INVOLVED

The relevant provisions of Sections 61, 162, 301, 316 and 482 of the Internal Revenue Code of 1954 are set forth in the Appendix, *infra,* pp. 11-13.

STATEMENT

Petitioners Flora J. Graves and R. L. Graves (the Graveses), at all relevant times prior to September 30, 1960, owned all the outstanding stock of The Challenger, Inc. The Graveses also owned all the stock of Sparks Development, Inc., during the years in issue. Petitioner Sparks Nugget, Inc., purchased all of the stock of The Challenger on September 30, 1960. Challenger was subsequently liquidated by Sparks Nugget, and the latter corporation is a party to this action only in its role as transferee of Challenger (Pet. App. 49-50).

a. *Rental of parking lots*

Challenger, in June of 1959, leased six and one-half lots located in Sparks, Nevada, from its sister corpora-

tion, Sparks Development. These lots were used by Challenger as parking lots in connection with its operation of a gambling casino known as the Sparks Nugget Casino (Pet. App. 48-49). The initial term of the lease was five years, and the rental was $9,400 per month for the first year and $8,000 monthly for the next four years. These rentals were determined by R. L. Graves, acting on behalf of both Challenger and Sparks Development, so as to provide the latter with sufficient income to pay his compensation, its income taxes, and its purchase obligations on the parking lots. During the taxable years 1959 and 1960, Challenger's parking lot rental expenditures totaled $37,000 and $107,200, respectively (Pet. App. 49-50).

The Commissioner, acting under Section 162 of the Internal Revenue Code of 1954, disallowed rental deductions claimed by Challenger with respect to its leasing of the parking lots to the extent the monthly payments exceeded $4,000 on the ground that the excess amounts were not ordinary and necessary business expenses. The Tax Court sustained his action, finding that the reasonable rental value of the parking lots did not exceed $4,000 per month (Pet. App. 17, 36-37). The court of appeals affirmed (Pet. App. 50-57).

b. *Rental of slot machines*

Challenger leased 100 slot machines from certain other corporations owned by the Graveses in 1955.[1] This lease continued in effect with terms unchanged

---

[1] Specifically, the lessors of the slot machines were The Pub, Inc., United Waldorf, Inc., and Saratoga Club Inc. (Pet. App. 60-61).

until 1960 when Challenger purchased all the machines at a total cost of $20,000. Challenger paid its sister corporations $97,336.07 during 1959 and $103,821.15 during 1960 in accordance with the terms of the lease. Computed on a monthly basis, these figures resulted in a monthly rental per machine of $81.11 in 1959 and $86.52 in 1960 (Pet. App. 60-61). The Commissioner determined that amounts in excess of $2.59 per month per machine were not bona fide rental payments, and, accordingly, disallowed claimed deductions for such amounts. In *Challenger, Inc.* v. *Commissioner,* 23 T.C.M. 2096, the Tax Court held that the reasonable rental value of these same slot machines did not exceed $2.59 per machine per month for the taxable years 1955 through 1958. Consequently, the Tax Court here held that by virtue of this prior decision against their wholly-owned corporation, Challenger, the Graveses were collaterally estopped from relitigating the reasonable rental value of the slot machines for the years 1959 and 1960. The Ninth Circuit agreed with the Tax Court's application of collateral estoppel (Pet. App. 61-62).

c. *Constructive dividends to the Graveses*

The Commissioner determined that the amounts diverted by the Graveses from Challenger to their other corporations in the form of excessive rental payments for the parking lots and slot machines were taxable to them as a constructive dividend. Both courts below held that the Commissioner's action was warranted since the Graveses had realized an immediate economic benefit from the distribution of Challenger's

earnings (Pet. App. 58-59). It is this determination which petitioners challenge here.

ARGUMENT

The decision below is correct. There is no conflict or any other reason for further review by this Court.

1. Sections 301(c)(1) and 316(a) of the Internal Revenue Code of 1954 (Appendix, *infra*, pp. 11-12) provide that a distribution to a stockholder out of a corporation's earnings and profits constitutes a dividend, and that such a distribution is includable in the stockholder's gross income. But it has long been settled that there may be a constructive dividend to a stockholder even though there is no formal declaration and distribution of a dividend. See *Clark* v. *Commissioner*, 266 F. 2d 698 (C.A. 9). The test is whether there is a diminution in the earnings and profits of a corporation which inures to the benefit of a stockholder, in one form or another. Familiar examples of constructive dividend situations are cases in which there is a transfer of corporate assets to a stockholder for a price which is less than the property's fair market value (*Waldheim* v. *Commissioner*, 244 F. 2d 1 (C.A. 7)), or in which a corporation pays a stockholder's debt to a third party (*Sachs* v. *Commissioner*, 277 F. 2d 879 (C.A. 8), certiorari denied, 364 U.S. 833), or where a corporation makes rental payments to a stockholder for use of his property in excess of the reasonable rental value of the property (*Limericks, Inc.* v. *Commissioner*, 165 F. 2d 483 (C.A. 5)).

In the same regard, the courts have consistently held that a stockholder who causes one of his corporations to

transfer a portion of its assets to a second corporation, owned or controlled by him, gratuitously or for inadequate consideration, realizes dividend income in the amount of earnings thus diverted. See, *e.g.*, *Sammons* v. *United States*, 433 F. 2d 728 (C.A. 5), certiorari denied, 402 U.S. 945; *Biltmore Homes, Inc.* v. *Commissioner*, 288 F. 2d 336 (C.A. 4), certiorari denied, 368 U.S. 825; *Worcester* v. *Commissioner*, 370 F. 2d 713 (C.A. 1). In these situations the stockholder is economically benefited by the enrichment of his second corporation, just as he is by the payment of a debt which he owes to a third party.

Here, the Graveses, under the guise of purported rental payments, diverted funds from their highly successful casino corporation (Challenger) to other corporations which they owned. The economic benefit to the Graveses from such diversion, justifying the imposition of a constructive dividend by both courts below, is clear. First, Challenger, despite its history of continuous and large earnings, never paid any dividends (Pet. App. 16). By diverting Challenger's earnings to several of their other corporations, the Graveses avoided the possibility of Challenger having to pay the accumulated earnings tax imposed by Section 531 of the Code. In addition, by transferring Challenger's earnings to passive corporations, the Graveses put themselves in a position whereby they could obtain these earnings, at capital gains rather than dividend rates (without affecting the income-producing Challenger), by simply selling or liquidating the recipient corporations. Finally, as both courts below pointed

out (Pet. App. 58-59), as a result of the payment of excessive rentals, the Graveses were able to build up the equity in Sparks Development so that when Challenger was sold they were left with a valuable corporation.[3]

2. Petitioners erroneously assert conflict with *Rubin* v. *Commissioner*, 429 F. 2d 650 (C.A. 2) (Pet. 6-8). In *Rubin*, the Second Circuit criticized the Tax Court for relying on Section 61 of the Code, Appendix, *infra*, p. 11 (which defines gross income), and on "common law" doctrines of taxation in determining that payments made by one corporation to another on account of services rendered to it by the controlling shareholder of both corporations (purportedly as an employee of the second corporation) were taxable to the controlling shareholder since he rather than his corporation earned the income. The court of appeals held that the Tax Court should have proceeded on the basis of Section 482, Appendix, *infra*, p. 13 (which permits the Commissioner to allocate income among controlled entities in certain circumstances) and remanded the case for a determination under this statute. On remand, the Tax Court reached the same result under Section 482

---

[3] Petitioners' contention (Pet. 14-16) that the decision of the court of appeals below conflicts with that of the Third Circuit in *Helsey* v. *Commissioner*, 258 F. 2d 865, is without merit. In *Helsey*, as the court of appeals noted (Pet. App. 58-59), the economic benefit to the shareholders was considered by the court to be too speculative to warrant the imposition of a constructive dividend. Moreover, in that case there was a certainty that the gains from the transactions involved would be subject to tax when actually realized. In contrast, the Graveses have sustained immediate benefit from the diversion of Challenger's earnings which gains would have escaped taxation but for the imposition of a constructive dividend.

as it had reached under Section 61 (56 T.C. 1155), and the court of appeals affirmed, *per curiam* (460 F. 2d 1216).

The court's holding in *Rubin* that application of Section 61 is inappropriate in cases where Section 482 is available is not inconsistent with the application of Section 162, Appendix, *infra*, p. 11, by both courts below. Sections 61 and 162 cannot be considered identical in breadth of scope. Section 61 is a catchall provision and is the broadest statute in the Code.[8] Section 162, on the other hand, pertains only to ordinary and necessary business expenses and is the specific statutory provision dealing with rental payments. Moreover, the decision of the Ninth Circuit below is in accord with numerous other decisions in which the courts have relied on Section 162 in determining whether rental payments between related parties were excessive. See, *e.g.*, *Southeastern Canteen Co.* v. *Commissioner*, 410 F. 2d 615 (C.A. 6); *Brown Printing Co.* v. *Commissioner*, 255 F. 2d 436 (C.A. 5); *Midland Ford Tractor Co.* v. *Commissioner*, 277 F. 2d 111 (C.A. 8).

Cases such as *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394, *B. Forman Co.* v. *Commissioner*, 453 F. 2d 1144 (C.A. 2), certiorari denied, 407 U.S. 934, and *Tennessee-Arkansas Gravel Co.* v. *Commissioner*, 112 F. 2d 508 (C.A. 6), relied on by petitioners (Pet. 9-12), raise factual and legal questions different from those involved here. These cases do not deal with the imposition of constructive dividends upon shareholders

---

[8] Indeed, the regulations under Section 61 (Treasury Regulations on Income Tax, § 1.61-1(b) (26 C.F.R.)) state that the statute is not to be applied where there is some other specific Code provision applicable.

but rather involve the allocation, under Section 482, of income among controlled corporations.

In any event, the application of Section 482 in lieu of Section 162 in this case would not have produced a different result, contrary to petitioners' contention[4] (Pet. 8-14). Whatever differences may exist between Sections 162 and 482 are of no consequence in determining whether the Graveses were properly charged with a constructive dividend. The constructive dividend consequence here flows simply from the fact that the Graveses realized immediate economic benefit as a result of having diverted Challenger's earnings to their other corporations. See *Sammons* v. *United States*, *supra*.

4. Finally, petitioners suggest (Pet. 16-18) that the imposition of a constructive dividend represents a constitutionally impermissible penalty. The Commissioner's determination that Challenger's rental payments were excessive produced no additional taxes at the corporate level, however, since amounts disallowed as deductions to Challenger were eliminated by the Commissioner from the taxable incomes of the lessor corporations on the ground that they were non-taxable contributions of capital by the Graveses. The only effect of the Commissioner's action, sustained by the

---

[4] The Commissioner filed amended answers in the Tax Court in which he raised Section 482 as an alternative basis for his determination of deficiencies in the income taxes of the Graveses. This alternative position was asserted in the government's brief in the court of appeals (pp. 34-37), and allegations by petitioners (Pet. 7, fn. 7) that the government conceded at oral argument that no constructive dividend would have resulted had Section 482 been applied are unfounded.

courts below, was that the Graveses were required to pay taxes on the funds they diverted from Challenger to their other corporations in the same manner as if there had been a direct distribution to them. There is nothing penal in this result.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

SCOTT P. CRAMPTON,
Assistant Attorney General.

BENNET N. HOLLANDER,
RICHARD FARBER,
Attorneys.

JANUARY 1973.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

* * *

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

* * *

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * *

SEC. 301. DISTRIBUTIONS OF PROPERTY.

* * *

(c) *Amount Taxable.*—In the case of a distribution to which subsection (a) applies—

(1) *Amount constituting dividend.*—That portion of the distribution which is a dividend

(as defined in section 316) shall be included in gross income.

* * *

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of it earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

* * *

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

☆ U.S. Government Printing Office: 1973—492-721/454